LATHAM&WATKINS

Number 1157 March 1, 2011

Client Alert

Latham & Watkins Litigation Department

An End to the Rule of Thumb: *Uniloc USA, Inc. v. Microsoft Corp.*

"This *Client Alert* discusses background of the *Uniloc* case, highlights the damages portion of the Federal Circuit's decision, which significantly impacts the law relating to the 25 percent rule and entire market value rule (EMVR), and concludes with observations for practitioners."

Before the Federal Circuit's recent decision in *Uniloc USA, Inc. v. Microsoft Corp.*, patentees often used the so-called 25 percent rule to approximate a reasonable royalty rate—*i.e.*, the royalty rate that an accused infringer would have paid to the patentee during a hypothetical negotiation at the time infringement began. That rule presumptively allocates 25 percent of the profit associated with a product to the licensor of a relevant patent. The *Uniloc* decision unambiguously prohibits reliance on this rule moving forward: "Evidence relying on the 25 percent rule of thumb is . . . inadmissible under *Daubert* and the Federal Rules of Evidence, because it fails to tie a reasonable royalty base to the facts of the case at issue." No. 2010-1035, 2011 WL 9738, at *19 (Fed. Cir. Jan. 4, 2011). This *Client Alert* discusses background of the *Uniloc* case, highlights the damages portion of the Federal Circuit's decision, which significantly impacts the law relating to the 25 percent rule and entire market value rule (the EMVR), and concludes with observations for practitioners. At the time this *Client Alert* is published, the parties are expected to file petitions for rehearing on March 7.

Background

Uniloc owns US Patent No. 5,490,216 (the '216 patent), which is directed to a software registration system to deter copying of software. Uniloc accused Microsoft's Product Activation feature for Word XP, Word 2003 and Windows XP of infringing independent claim 19 of the '216 patent.

On remand from a prior Federal Circuit appeal (which reversed and remanded summary judgment of noninfringement), the district court denied several motions in *limine* before holding a jury trial. Specifically, the trial court denied Microsoft's motion to exclude testimony by Uniloc's damages expert under *Daubert* and Rule 702 of the Federal Rules of Evidence because, among other things, the expert used the 25 percent rule.

The jury returned a verdict of willful infringement and no invalidity of the asserted claim, and awarded $388 million in damages to Uniloc. Microsoft moved for judgment as a matter of law (JMOL) on a number of issues. The district court (1) denied JMOL of invalidity, (2) granted JMOL of noninfringement, (3) granted JMOL of no willfulness, (4) granted a new trial on damages based on Uniloc's improper use of the entire market value rule and (5) granted in the alternative a new trial on infringement and willfulness. Uniloc appealed the grants of JMOL and new trial on damages, and Microsoft cross-appealed denial of JMOL on invalidity.

The Appeal

The Federal Circuit issued a comprehensive decision touching on various aspects of infringement, willfulness, invalidity and damages. This *Client Alert*, however, focuses on the damages portion concerning the application of the 25 percent rule and the entire market value rule.

There, the Federal Circuit affirmed the district court's grant of a new trial on damages based on improper use of the 25 percent rule and the EMVR by Uniloc's expert. Under 35 U.S.C. § 284, damages shall be "adequate to compensate for the infringement, but in no event less than a reasonable royalty for the use made of the invention by the infringer." The reasonable royalty is commonly calculated based on a hypothetical negotiation between the parties at the time infringement began.

Uniloc's damages expert opined on a reasonable royalty rate purportedly based on such a hypothetical negotiation. His analysis started with an internal Microsoft document stating that "a Product Key is worth anywhere between $10 and $10,000 depending on usage." *Uniloc*, 2011 WL 9738 at *15. The expert then applied the "25 percent rule of thumb" to $10, notably for no reason specific to the facts of this case, and arrived at a baseline royalty rate of $2.50 per license issued. He also considered several *Georgia Pacific* factors with a view toward adjusting the baseline royalty rate up or down, albeit ultimately concluding that no adjustment was needed. Uniloc's expert then calculated a reasonable royalty by multiplying $2.50 by the number of new licenses to Office and Windows products, ultimately concluding that a reasonable royalty is almost $565 million. He also "checked" this reasonable royalty amount by applying the EMVR. In other words, he applied the EMVR (though its application here was questionable under *Lucent Technologies, Inc. v. Gateway, Inc.*, 580 F.3d 1301 (Fed. Cir. 2009)) to determine if it gave a damages amount that was similar to the damages calculated by applying the 25 percent rule, which he opined confirmed the validity of that rule and its application in this case.

The 25 Percent Rule

The 25 percent rule is a tool "used to approximate the reasonable royalty rate that the manufacturer of a patented product would be willing to offer to pay to the patentee during a hypothetical negotiation." *Id.* at *16 (citing Robert Goldscheider, et al., *Use Of The 25 Per Cent Rule in Valuing IP, 37 les Nouvelles* 123, 123 (Dec. 2002) (*Valuing IP*)). Specifically, the rule suggests that a licensee would pay 25 percent of its expected profits for the product that incorporates the patented technology. This rule has long been used by economists and other damages experts as a basis for their damages opinions in patent cases. *Id.* at *18 (collecting several district court decisions, including *Procter & Gamble Co. v. Paragon Trade Brands, Inc.*, 989 F. Supp. 547, 612 (D. Del. 1997)).

The *Uniloc* case questioned the admissibility of the 25 percent rule, and the Federal Circuit viewed the issue as one of first impression. *Id*. The Federal Circuit acknowledged "passively tolerat[ing]" use of the rule in previous cases and noted that district courts "invariably admitted evidence based on the 25 percent rule, largely in reliance on its widespread acceptance or because its admissibility was uncontested." *Id.*

But deciding the issue in this case, the Federal Circuit unequivocally held that "[e]vidence relying on the 25 percent rule of thumb is . . . inadmissible under *Daubert* and the Federal Rules of Evidence, because it fails to tie a reasonable royalty base to the facts of the case at issue." *Id*. at *19. In finding testimony based on the rule inadmissible, the Court explained that "the 25 percent rule of thumb is a fundamentally flawed tool for determining a baseline royalty rate in a hypothetical negotiation." *Id*.

The Court further explained that critical to assessing the admissibility of expert testimony is whether the expert "has justified the application of a general theory to the facts of the case." *Id*. at *19-20 (discussing *General Electric Co. v. Joiner*, 522 US 136 (1997), and *Kumho Tire Co. v. Carmichael*, 526 US 137 (1999)). In the context of patent damages, "there must be a basis in fact to associate the royalty rates used in prior licenses to the particular hypothetical negotiation at issue in the case." *Id*. at *20-21 (discussing *Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d 1301 (Fed. Cir. 2009), *ResQNet.com, Inc. v. Lansa, Inc.*, 594 F.3d 860 (Fed. Cir. 2010), and *Wordtech Sys. Inc. v. Integrated Networks Solutions, Inc.*, 609 F.3d 1308 (Fed. Cir. 2010)). By contrast, "[t]he 25 percent rule of thumb as an abstract and largely theoretical construct fails to satisfy this fundamental requirement. The rule does not say anything about a particular hypothetical negotiation or reasonable royalty involving any particular technology, industry, or party." *Id*. at *21. Moreover, "[i]t is of no moment that the 25 percent rule of thumb is offered merely as a starting point to which the *Georgia-Pacific* factors are then applied to bring the rate up or down." *Id*.

The Federal Circuit *did* reaffirm that use of the Georgia Pacific factors to frame the reasonable royalty inquiry is proper. *Id*. Nevertheless, "evidence purporting to apply [these factors] must be tied to the relevant facts and circumstances of the particular case at issue and the hypothetical negotiations that would have taken place in light of those facts and circumstances at the relevant time." *Id*.

The Entire Market Value (EMVR)

The Federal Circuit rejected the expert's use of the EMVR as a "check" because Uniloc failed to prove that the patented feature is the basis for customer demand of the infringing product. "The entire market value rule allows a patentee to assess damages based on the entire market value of the accused product only where the patented feature creates the 'basis for customer demand' or 'substantially create[s] the value of the component parts.'" *Id*. at *22 (alteration in original) (citations omitted). Here, the Court rejected Uniloc's argument that application of the EMVR is appropriate if the royalty rate is sufficiently low. *Id*. at *24. The Federal Circuit also explained that "[e]ven if the jury's damages calculation was not based wholly on the entire market value check, the award was supported in part by the faulty foundation of the entire market value"—*i.e.*, "that the entire market value rule was brought in as only a 'check' is of no moment." *Id*. at *25.

Observations for Practitioners

The *Uniloc* decision, which continues a recent line of Federal Circuit decisions heightening scrutiny applied to significant damages awards, will influence how practitioners prepare the damages portion of a case for trial. In short, the oft-relied on 25 percent rule of thumb is probably no more, and the application of the EMVR (even as a check) may likely require a showing that the patented feature is the basis for customer demand of the infringing product. The following are some exemplary observations for practitioners, who should begin developing their damages theory as part of early case assessment.

First, the Federal Circuit has made clear that the damages analysis must be closely tied to the particular patents, technologies, industries and products at issue in the case at hand. Going forward, patentees will not be permitted to present damages numbers that lack any basis in the particular facts of the case, such as those derived from the 25 percent rule. Instead, patentees must find or develop case-specific factual evidence to support their damages numbers. This makes it important to figure out what those damages-related facts are early in the case. In the past, these facts may have gotten short shrift, by patentees who preferred to present damages theories that may not have been tied to the particular patents, technologies and products at issue in the case and by defendants who wanted to focus the jury on noninfringement and invalidity arguments, rather on how much they may have to pay for any infringement. That appears likely to change, and damages-related evidence should be part of early case assessment. Considerable uncertainly will still remain, however, as key facts will often not be known until well into the process of discovery.

Second, recent Federal Circuit damages case law has made it harder for plaintiffs to obtain damages that are out of proportion with the importance of the claimed functionality to the infringing product. *Uniloc* suggests that patentees are likely not permitted to use the price of downstream products incorporating the accused functionality in any way (even as a “check”) unless they are able to prove up the elements of the EMVR, including that the patented feature is the basis for customer demand of the product. As a result, it is probably more important than ever for patentees and accused infringers to consider the pros and cons of conducting consumer surveys to assess whether the accused functionality is the basis for customer demand of downstream products. Parties might also consider involving a damages expert early in the discovery process and asking the expert what other evidence she needs to evaluate whether the patented feature is the basis for customer demand of the infringing product. Lastly, accused infringers in particular should review their document production and discovery responses with an eye toward whether any document or information would support or refute application of the EMVR.

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